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9 **BEFORE THE ARIZONA CORPORATION COMMISSION**

10 IN THE MATTER OF THE APPLICATION OF
11 ARIZONA WATER COMPANY, AN ARIZONA
12 CORPORATION, FOR A DETERMINATION OF
13 THE FAIR VALUE OF ITS UTILITY PLANT
14 AND PROPERTY, AND FOR ADJUSTMENTS
15 TO ITS RATES AND CHARGES FOR UTILITY
16 SERVICE AND FOR CERTAIN RELATED
17 APPROVALS BASED THEREON.

Docket No. W-01445A-08-0440

**Notice of Filing Surrebuttal
Testimony**

18 Abbott Laboratories, through its undersigned counsel, hereby provides notice of filing the
19 Surrebuttal Testimony of Dan L. Neidlinger in the above-referenced matter.

20 RESPECTFULLY SUBMITTED this 12th day of August 2009.

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Arizona Corporation Commission

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2 foregoing filed this 12th day of August 2009
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8 Copies of the foregoing mailed this 12th day
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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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3 COMMISSIONERS

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5 GARY PIERCE
6 SANDRA KENNEDY
7 PAUL NEWMAN
8 BOB STUMP

9 IN THE MATTER OF THE APPLICATION OF
10 ARIZONA WATER COMPANY, AN ARIZONA
11 CORPORATION, FOR A DETERMINATION OF
12 THE FAIR VALUE OF ITS UTILITY PLANT
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16 APPROVALS BASED THEREON.

Docket No. W-01445A-08-0440

17 **Surrebuttal Testimony**
18 **of**
19 **Dan L. Neidlinger**
20 **August 12, 2009**
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**Surrebuttal Testimony
of
Dan L. Neidlinger
August 12, 2009**

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Executive Summary

Dan Neidlinger is President of Neidlinger & Associates, Ltd, a consulting firm specializing in utility rate economics. Mr. Neidlinger has extensive rate case experience and has testified in cases in front of the Commission, as well as regulatory commissions in Alaska, California, Colorado, Guam, Idaho, New Mexico, Nevada, Texas, Utah, Wyoming, and Alberta Province, Canada.

Mr. Neidlinger addresses the class cost of service study ("COSS") and rate design testimony provided previously in this case by Staff witnesses Steve Olea and Jeffrey Michlik.

Mr. Neidlinger agrees generally with Company witness Joel Reiker's and RUCO witness Rodney Moore's class rate adjustments because the Company's and RUCO's proposals move commercial and industrial rates in the Casa Grande system closer to the cost of service. The Staff witnesses, on the other hand, propose rate changes that move rates farther away from the cost of service.

Mr. Neidlinger testifies that cost of service is the single-most important criterion in the development of revenues by customer class and in the development of rates to produce those revenues. Failure to adjust rates to match the cost of providing service results in subsidies among classes of customers and customers within a class. Rates based upon cost of service are equitable because each customer pays its fair share of the utility's total costs.

Even though present industrial rates in the Casa Grande system already have a rate of return of over 51%, or 20 times the overall system return, Staff is recommending an additional revenue increase for the industrial class such that the rate of return will jump to 90%. Staff's recommendation is excessive, contrary to Staff's statement that Staff utilized the COSS in its rate proposal, and is not supported by accepted ratemaking standards. Because Staff's proposal recommends rates for the commercial and industrial classes in the Casa Grande system that move the rates farther away from cost of service, Staff's proposal is contrary to the concept of gradualism. Staff's proposed rate design fails to promote conservation because some users will continue to pay less than cost for their water service. Staff proposes a "one size fits all" approach to uniformity in ratemaking that fails to take into account the significant customer diversity in the Casa Grande system, and fails to provide adequate revenue stability and predictability.

The Staff's rate recommendations for the Casa Grande system should be rejected for all these reasons. They are arbitrary and exacerbate the existing inequitable cost/price relationships for the commercial and industrial customers. The industrial class is already providing 51% returns, returns that no customer should be asked to bear. Staff unjustly recommends even higher returns of 90% on the industrial class. The Company's and RUCO's recommendations are superior because they are based upon the cost of providing service and should be adopted in this case.

1 **I. Introduction**

2 **Q. Please state your name, address, and occupation.**

3 A. My name is Dan L. Neidlinger. My business address is 3020 North 17th Drive, Phoenix,
4 Arizona. I am President of Neidlinger & Associates, Ltd., a consulting firm specializing
5 in utility rate economics.

6 **Q. Please describe your professional qualifications and experience.**

7 A. A summary of my professional qualifications and experience is included in the attached
8 Statement of Qualifications. In addition to providing testimony before the Arizona
9 Corporation Commission ("ACC" or "Commission"), I have presented expert testimony
10 before regulatory commissions and agencies in Alaska, California, Colorado, Guam,
11 Idaho, New Mexico, Nevada, Texas, Utah, Wyoming and the Province of Alberta,
12 Canada.

13 **Q. On whose behalf are you appearing in this proceeding?**

14 A. I am appearing on behalf of Abbott Laboratories ("Abbott"). Abbott receives water
15 service from Arizona Water Company's ("AWC" or "Company") Casa Grande System
16 under AWC's 6" Industrial Rate Schedule. A detailed description of Abbott's Casa
17 Grande operations, its water treatment system and its water conservation program is
18 provided in the direct testimony of Stephen V. Chasse, Manager of Facilities and Utilities
19 for the Casa Grande plant.
20

21 **II. Purpose of Testimony**

22 **Q. What is the purpose of your surrebuttal testimony in this case?**

23 A. My surrebuttal testimony addresses the class cost of service study ("COSS") testimony of
24 Staff witness Steven Olea and the class revenue and rate design testimony of Staff
25 witness Jeffery Michlik for the Company's Casa Grande system. I did not perform an
26 overall revenue requirements study for the Casa Grande system and accordingly have no
27 opinion on this issue.
28

1 **III. Cost of Service Study and Rate Design**

2 **Q. Did you review the COSS and rate design testimony of Company witness Joel**
3 **Reiker and the rate design testimony of RUCO witness Rodney Moore?**

4 A. Yes. I am in general agreement with the class rate adjustments proposed by Mr. Reiker
5 since they move rates closer to cost of service in contrast to Staff's proposals that move
6 rates away from cost of service. Similarly, I concur in general with the rate design
7 recommendations of Mr. Moore for the Casa Grande system since they are also appear to
8 move customer class returns closer to cost of service.

9 **Q. Was the Company required, pursuant to ACC Rule R14-2-103, to file a COSS for**
10 **each of its operating systems?**

11 A. Yes. All large utilities, including AWC, are required to file a COSS supporting their rate
12 design proposals for each class of customer. When Rule R14-2-103 was adopted in the
13 1970s, the Commission recognized the need for COSS in setting rates that are fair and
14 equitable. Although the Rule has been amended from time to time since its initial
15 adoption, the COSS series of schedules remain today an important component of any rate
16 filing package for all large utilities, including water utilities.

17 **Q. Why is Cost of Service Important?**

18 A. In a regulated environment, cost of service is the single-most important criterion in the
19 development of revenues by customer class and the development of rates that will
20 produce those revenues. If rates are not cost-based, the inevitable results are subsidies
21 among classes of customer and customers within a class. Although other factors, such as
22 continuity, simplicity, and stability are valid considerations in the rate design process, the
23 primary guideline should be cost of service. Rates developed based on cost of service are
24 equitable because each customer pays its fair share of the utility's total costs.
25
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1 **Q. Did you review the COSS testimony of Staff witness Olea?**

2 A. Yes. Mr. Olea critiqued the Company's Casa Grande COSS and recommended changes
3 to the percentage factors used to functionalize certain expense and plant accounts. He
4 also prepared two modified or truncated COSS summaries for the Casa Grande system:
5 one at present rates and one at Staff's proposed rates. I have prepared a summary of the
6 results of Mr. Olea's truncated study including Staff's recommended class revenue
7 increases as shown on the attached Exhibit DLN-1. As indicated in the second column on
8 Exhibit DLN-1, Staff is recommending revenue increases for the commercial and
9 industrial classes that exceed 48% or 1.3 times the total system-wide increase of 37%.
10 The proposed increases for these two classes are in direct contradiction to the results of
11 Mr. Olea's COSS. As shown in the third column on Exhibit DLN-1, the rate of return at
12 present rates for the commercial class is already 7.5%, or 3 times the current overall
13 system-wide return of 2.5%, and the rate of return for the industrial class is already over
14 52%, or 20 times the overall system-wide return. However, instead of decreasing the
15 returns for these classes, Staff's new proposed rates substantially increase the returns.
16 The excessive return currently provided by the industrial class suggests a rate reduction
17 would be appropriate -- and certainly does not support a 48% increase. One can only
18 conclude from a brief review of Exhibit DLN-1 that Staff ignored the results of its own
19 COSS.

20 **Q. Did Mr. Olea develop the class revenue targets for the Casa Grande System?**

21 A. No, I don't believe so. Responses to Abbott and Company data requests to the Staff on
22 this question indicate that Mr. Michlik was responsible for developing class revenue
23 requirements. Mr. Olea provided some guidance to Mr. Michlik with respect to small
24 meter rate design.

25 **Q. Did you review the revised COSS presented by Company witness Reiker in**
26 **conjunction with his COSS and rate design rebuttal testimony?**

1 A. Yes. Mr. Reiker adopted Mr. Olea's recommendations with respect to functionalization
2 factors and prepared a complete update of the Company's COSS. As part of this update,
3 he prepared COSS schedules for the Casa Grande system that mirror Mr. Olea's analysis
4 using Staff's adjusted rate base, operating expenses and recommended class revenues. I
5 have prepared a summary of Mr. Reiker's update for the Casa Grande system as shown
6 on Exhibit DLN-2. Although a comparison of class returns between the two studies
7 indicates that the results are comparable, Mr. Reiker's updated COSS appears to be more
8 complete than Mr. Olea's truncated COSS and a truer reflection of the effect of Staff's
9 class revenue proposals. As indicated in the third column on Exhibit DLN-2, the return
10 on rate base at Staff's proposed rates for the commercial class is increased from 15% to
11 18% and the return for the industrial class jumps from 73% to 90%. Regardless of the
12 increase in return percentage one might pick, the proposed increase to the industrial class
13 is excessive and unsupportable by any acceptable ratemaking standard.

14 **Q. How did Mr. Michlik determine class revenue requirements for the Casa Grande**
15 **system?**

16 A. I don't know. Mr. Michlik's testimony is silent with respect to the approach that he used
17 in developing class revenue targets and related rates, what he considered in his analysis,
18 and why his rate recommendations differ so greatly from those of the Company. I found
19 no substantive foundation for the rates he recommends. The bulk of his testimony
20 discusses the rate impacts of his proposed rates for only the residential class with no
21 discussion on the effect of his proposed rates on other customers. In essence, his
22 testimony consists of "Please see the attached rates." Abbott asked Staff¹ to provide the
23 basis for developing its class revenue targets. The response from Mr. Michlik was as
24 follows: "Staff utilized the Cost of Service Study, as a general guideline, but also
25

26 ¹ Abbott Data Request 1-5: "Please explain the basis for, and manner in which, class revenue targets, for rate
27 design purposes, were set for the Casa Grande System."
28

1 considered other factors. Other factors include, but are not limited to gradualism,
2 conservation, uniformity and other concepts that do not rely solely on cost of service
3 information.” As previously stated, I can only conclude from Staff’s class revenue
4 recommendations that the results of the COSS prepared by Mr. Olea and that of Mr.
5 Reiker were ignored. It is not logical to assert reliance on COSS as a guideline and then
6 propose increasing the return on rate base for the industrial class from 50% to 90%. The
7 industrial class is already providing an excessive return. As is further discussed in my
8 testimony, I also disagree that Staff has properly considered the factors of gradualism,
9 conservation or uniformity in determining class revenue targets.

10 **Q. Are Mr. Michlik’s rate recommendations consistent with the concept of**
11 **gradualism?**

12 A. No. Staff has turned the concept of gradualism on its head. Gradualism is premised on
13 the desire to move rates toward cost of service while minimizing, if possible, large rate
14 adjustments. As shown on the previously discussed Exhibits DLN-1 and DLN-2, Mr.
15 Michlik’s recommends larger-than-average increases for the commercial and industrial
16 classes that move both of these classes further away from, rather than closer to, cost of
17 service, which is contrary to the concept of gradualism.

18 **Q. Did Staff provide any explanation as to how it applied the concept of gradualism in**
19 **this case?**

20 A. No.

21 **Q. How can gradualism be treated in ratemaking proceedings?**

22 A. There are a number of approaches to the implementation of gradualism, most of them
23 judgment-based. One quantitative guideline that has often been applied by some analysts
24 and one that Staff might have used is the 50/150 rule whereby percentage increases to
25 major customer classes that over-earn are capped at 50% of the overall percentage
26 increase and the under-earning classes are capped at 150% of the overall percentage
27 increase. This approach was obviously not considered by Staff since its recommended
28

1 increases to the over-earning commercial and industrial classes that far exceed 18.5%
2 (50% of the overall increase of 37%).

3 **Q. What about conservation?**

4 A. An inverted tier rate design is admittedly one element of a water conservation program
5 for a water utility, but it must be applied within the context of cost-based rates.
6 Conservation is not a valid argument for designing rates, as proposed in this case by Mr.
7 Michlik, which create large cross-subsidies among classes of customers. It is ironic that
8 the two industrial customers on AWC's Casa Grande system that have already achieved
9 significant reductions in water usage through the implementation of water conservation
10 programs are now asked to bear rate increases greater than other customers on the Casa
11 Grande system, many of whom, under Staff's proposals, will continue to pay less than
12 cost for their water service.² As Mr. Reiker clearly states in his rebuttal testimony,³ the
13 goal of conservation is best achieved by charging customers rates based on cost of
14 service.

15 **Q. Has Mr. Michlik correctly applied in this case the concept of uniformity in rate**
16 **design?**

17 A. No. In response to Abbott's data request, Staff did not explain what it meant by
18 "uniformity." It appears that Mr. Michlik views uniformity to mean that all commodity
19 rates should be equal for all customers. This "one size fits all" approach to ratemaking
20 produces disastrous results for a water system such as Casa Grande that serves many very
21 small customers and a few extremely large customers. This size variance also produces
22 large variances in the cost to serve which have not been properly recognized in Mr.
23 Michlik's proposed rates. This degree of customer diversity is normally not present in
24

25 ² See the extensive discussion of water conservation in the Direct Testimony of Abbott's Stephen V. Chasse and
26 Company Rebuttal Testimony of William M. Garfield.

27 ³ See Rebuttal Testimony of Company Witness Joel Reiker, Page 11 at Line 3.
28

1 most investor-owned water utilities in Arizona. Accordingly, the Casa Grande system is
2 unique and requires rate adjustment approaches tailored to the heterogeneous nature of its
3 customer base.

4 **Q. Are there other important rate design attributes not mentioned by Mr. Michlik?**

5 A. Yes. The most important of these, in my view, are revenue stability and predictability.
6 As discussed in detail in the rebuttal testimonies of Company witnesses Garfield and
7 Reiker, the continued water conservation programs of large industrial customers will
8 likely result in a significant revenue shortfall for the Company should Mr. Michlik's
9 proposed rates for these customers be adopted. He evidently did not consider this
10 important ratemaking attribute. When setting rates for a utility, it is incumbent on the
11 rate analyst to recommend, and the regulator to adopt, rates that have a high probability
12 of achieving the desired level of revenues.

13
14 **IV. Conclusion**

15 **Q. Please summarize your conclusions and recommendations.**

16 A. The Staff's rate recommendations for the Casa Grande system should be rejected for the
17 reasons previously discussed. They are arbitrary and exacerbate the existing inequitable
18 cost/price relationships for commercial and industrial customers. The industrial class is
19 providing returns (51%) at present rates that far exceed the return on investment that any
20 utility customer should be required to pay, yet Staff suggests that these returns should be
21 increased to even greater levels (90%). Accordingly, I urge the Commission to adopt
22 ratemaking adjustments in this case that parallel the recommendations of the Company
23 and RUCO since they are based on cost of service.

24 **Q. Does this conclude your surrebuttal testimony?**

25 A. Yes, it does.
26
27
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EXHIBIT DLN - 1

ARIZONA WATER COMPANY
Docket No. W-01445A-08-0440
Class Cost of Service - Casa Grande System
Staff Proposed Class Revenue Increases and Returns on Rate Base
Staff Witness Steve Olea's Cost of Service Analysis

CUSTOMER CLASS	WATER REVENUES			RETURN ON RATE BASE	
	AT PRESENT	AT PROPOSED	PERCENT INCREASE	AT PRESENT	AT PROPOSED
	RATES (1)	RATES (2)		RATES (3)	RATES (2)
Residential	\$6,578,153	\$8,769,566	33.31%	0.24%	4.52%
Commercial	2,217,848	3,302,139	48.89%	7.53%	15.08%
Industrial	1,085,226	1,610,759	48.43%	52.12%	72.52%
Other	450,777	509,059	12.93%	4.55%	6.12%
Direct Private Fire	13,267	26,721	101.41%	-5.89%	-2.21%
Total Casa Grande System	<u>\$10,345,271</u>	<u>\$14,218,244</u>	<u>37.44%</u>	<u>2.54%</u>	<u>7.54%</u>

NOTES:

- (1) Schedule SMO-1, Schedule G-1
- (2) Schedule SMO-2, Schedule G-2
- (3) Calculated from Schedule SMO-1, Schedule G-1

EXHIBIT DLN - 2

ARIZONA WATER COMPANY
Docket No. W-01445A-08-0440
Class Cost of Service - Casa Grande System

Staff Proposed Class Revenue Increases and Returns on Rate Base
Company Witness Joel Reiker's Analysis of Staff Position - Rebuttal Testimony

CUSTOMER CLASS	WATER REVENUES			RETURN ON RATE BASE	
	AT PRESENT RATES (1)	AT PROPOSED RATES (2)	PERCENT INCREASE	AT PRESENT RATES (1)	AT PROPOSED RATES (2)
Residential	\$6,578,153	\$8,769,566	33.31%	0.18%	4.67%
Commercial	2,217,848	3,302,139	48.89%	7.63%	18.25%
Industrial	1,085,226	1,610,759	48.43%	50.99%	90.42%
Other	450,343	509,059	13.04%	5.05%	7.29%
Direct Private Fire	13,267	26,721	101.41%	-1.68%	0.31%
Total Casa Grande System	\$10,344,837	\$14,218,244	37.44%	2.52%	8.54%

NOTES:

- (1) Exhibit JMR-Staff 1, Schedule G-1
- (2) Exhibit JMR-Staff 1, Schedule G-2